No. 9901

In the United States Circuit Court of Appeals for the Ninth Circuit

Fontana Power Company, a Corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The only previous opinion is that of the Board of Tax Appeals (R. 5–21) reported in 43 B. T. A. 1090.

JURISDICTION

This appeal involves income and excess profits taxes for the years 1935, 1936 and 1937 and is taken from a decision of the Board of Tax Appeals entered March 29, 1941. (R. 21–22.) The case is brought to this Court by petition for review filed July 10, 1941 (R. 22–24), under the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether payments, amounting to all profits after operating expenses, taxes, and an eight percent divi-

dend, made to the only stockholder (other than qualifying shares) of the taxpayer pursuant to an agreement entered into in 1917 were deductible from the gross income of the taxpayer under Section 23 of the Revenue Acts of 1934 and 1936 or whether such payments constituted nondeductible payments in the nature of dividends.

STATUTES INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the

taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

* * * * *

(U. S. C., Title 26, Sec. 23.)

Sec. 115. Distributions by corporations.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

* * * * *

(U. S. C., Title 26, Sec. 115.)

Revenue Act of 1936, c. 690, 49 Stat. 1648:

The provisions of Section 23 (a) and (b) are identical with those of the Revenue Act of 1934, above quoted.

Sec. 115. Distributions by corporations.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

STATEMENT

The material facts, summarized from the findings of the Board of Tax Appeals are as follows (R. 7–13):

The taxpayer was incorporated in California in 1916 and has continuously operated as a public utility subject to the jurisdiction of the Railroad Commissioner of the State of California. The Fontana Union Water Company was also incorporated in California in 1912. It has been held by the Bureau of Internal Revenue to be exempt under Section 101 of the Revenue Act of 1934 and 1936 from income and capital stock taxation. The Fontana Company, incorporated in California prior to the taxpayer, was dissolved in 1927. All three companies had the same president. (R. 7.)

Prior to August 9, 1916, the taxpayer applied to the Railroad Commission for a certificate of public convenience and necessity in regard to the construction of an electrical power plant and system, for authority to execute a mortgage on its properties issuing thereunder $350,000 face amount of first mortgage six percent bonds, and for permission to acquire from the Water Company and the Fontana Company certain properties. Later in the same year, the taxpayer filed a supplemental application stating that it appeared impossible to submit sufficient data for the Commission to determine the value of the properties and that an option owned by the taxpayer for the purchase of certain steel would expire shortly and that thereafter the price of the steel would be considerably higher. Taxpayer proposed to enter into an agreement providing for the immediate conveyance of the properties to

it. The consideration was 100 shares of capital stock of the taxpayer, the taxpayer's agreement to pay the vendors the difference between the value of the 100 shares and the value of the properties as soon as the value and the method of payment could be agreed upon by the three companies and approved by the Commission, and the further agreement of the taxpayer that meanwhile it would pay to the vendors all its earnings after providing for the payment of operating expenses, taxes and interest on all obligations which it might incur. (R. 7–9.)

On October 10, 1916, the Railroad Commission granted authority for the issuance of 100 shares of capital stock of the taxpayer at a par value of $100 as part payment to the vendors and permission to issue the $350,000 principal amount of its first mortgage six percent bonds. Authority was also granted to enter into the proposed contract with the vendors. Subsequent orders were issued approving the mortgage and trust deed and stating that the bonds were secured by a mortgage on all of taxpayer's property, then owned or thereafter acquired. In 1937 it was provided that taxpayer could deduct charges for discount of the outstanding bonds in calculating net income under the agreement. (R. 9–10, 11.)

The bonds were issued in the amount of $350,000 and the proceeds were used in the development of taxpayer's property. The property and rights acquired from the vendors were leased by the taxpayer to the Southern California Edison Company for 30 years beginning July 1, 1917. The lessee operates the property and pays rental based upon the power generated in excess

of that required by the taxpayer for supplying its customers. (R. 10, 12.)

Upon incorporation five qualifying shares were issued, and pursuant to the agreement 50 shares each were issued to the Water Company and the Fontana Company. In 1927 the Fontana Company was dissolved (R. 7) and the Water Company acquired its 50 shares and all of its rights under the agreement. The Water Company has been, and still is, the owner of the 100 shares which, along with the five qualifying shares, are the only shares that have ever been issued. (R. 10–11.)

The value of the properties conveyed to the taxpayer by the Water Company and the Fontana Company has never been fixed, nor has the method of payment been determined. In fact, no attempt has been made to value it or to secure approval of the Railroad Commission. Since the beginning of taxpayer's operations in 1917, all of its net income in excess of operating and other expenses and an 8 percent dividend on its outstanding capital stock has been paid to the Water Company and/or the Fontana Company pursuant to the agreement. The taxpayer has never acquired any property of substantial value other than that conveyed to it by the vendors and that acquired from the proceeds of the sale of the bonds. From 1917 to date, taxpayer has deducted from its gross income the payments made in its federal tax returns and its annual reports to the Railroad Commission. (R. 11–13.)

The Commissioner determined deficiencies in income tax for the years 1935, 1936 and 1937 in the amounts of \$2,536.66, \$1,758.22 and \$3,130.50, respectively, and also deficiencies in excess profits tax in the respective

amounts of $922.42, $189.87 and $2,787.58, as the result of disallowing as deductions the payments made pursuant to the agreement. (R. 1, 6.) The Board of Tax Appeals affirmed the Commissioner's determination and the taxpayer has brought the case here for review.

SUMMARY OF ARGUMENT

Since the taxpayer is seeking a deduction from gross income, it must affirmatively show that the claimed deductions come strictly within the statutory provisions. Many cases of a similar nature have been decided and it is well recognized that they depend upon the facts and circumstances of each particular situation. Here the stock represents the full value of the assets and there should be no tax deduction for payment of the profits to the stockholders. There was no creditor relationship and the payments could not be termed "interest" in view of the actual situation. The payments were not similar to ground rents, nor were they necessary and ordinary expenses of the business of the taxpayer.

ARGUMENT

The payments were not deductible because they were distributions in the nature of dividends

In attempting to bring these payments within the limitations established by Congress for deductions from gross income, the taxpayer argues that the payments were made to the Water Company as creditor and not as stockholder (Br. 10–29); that the payments constituted interest (Br. 30–32); and that they were ordinary and necessary expenses of the business (Br.

33–35). Taxpayer has emphasized that payments were attributable to the agreement, which was made in respect to the purchase of the properties (Br. 10–18), and that the taxpayer could not under the laws of California have issued stock without the approval of the State Commission nor could it have created a stock interest with rights like those created by this agreement (Br. 19–22).

It cannot be denied that the taxpayer is seeking a deduction from gross income and therefore must strictly comply with the statutory standards. *Deputy* v. *DuPont,* 308 U. S. 488. It hardly seems necessary to labor the point that it is well recognized that the numerous cases involving this particular question are based fundamentally upon the particular facts and circumstances. *Commissioner* v. *Proctor Shop,* 82 F. (2d) 792 (C. C. A. 9th). There have been numerous instances where payments or distributions have been held to be dividends although they were labeled, or appeared to be, something else. It is clearly not necessary that the particular distribution be termed a dividend. Among the payments which have been held dividend distributions may be noted the following: distributions from a trust (*Angelus Building & Investment Co.* v. *Commissioner,* 57 F. (2d) 130 (C. C. A. 9th), certiorari denied, 286 U. S. 562); excessive salaries (*Doernbecher Mfg. Co.* v. *Commissioner,* 95 F. (2d) 296 (C. C. A. 9th)); redemption of outstanding stock (*Hill* v. *Commissioner,* 66 F. (2d) 45 (C. C. A. 4th)); cash withdrawals (*Hudson* v. *Commissioner,* 99 F. (2d) 630 (C. C. A. 6th), certiorari denied, 306 U. S.

644); transfer of certificates of interest in a newly organized company (*Continental Co.* v. *United States,* 259 U. S. 156, 176–177); interest on preferred stock (*United States* v. *South Georgia Ry. Co.,* 107 F. (2d) 3 (C. C. A. 5th)); rent paid to controlling stockholder (*LeMoyne* v. *Commissioner,* 47 F. (2d) 539 (C. C. A. 9th)); payments on certificates of deposit (*Bakers' Mutual Coop. Ass'n* v. *Commissioner,* 117 F. (2d) 27 (C. C. A. 3d)); payments on "debenture preferred stock" (*Brown-Rogers-Dixson Co.* v. *Commissioner,* 122 F. (2d) 347 (C. C. A. 4th)). Moreover, it is not necessary that there be a formal dividend declaration in order that the payment may be considered for tax purposes as a dividend. *Chattanooga Sav. Bank* v. *Brewer,* 17 F. (2d) 79 (C. C. A. 6th), certiorari denied, 274 U. S. 751. Nor can the principal stockholder complain that a distribution is not actually a dividend on the ground that a minority interest, such as qualifying shares, did not participate in the distribution. *Christopher* v. *Burnet,* 55 F. (2d) 527 (App. D. C.).

The distributions in this case were made pursuant to an agreement whereby the taxpayer acquired certain properties. Under the agreement the taxpayer issued its stock as part consideration; agreed to pay to the vendors the difference between the value of the stock and the value of the properties; and pending the determination of that difference, agreed to pay to the vendors all of its profits. For twenty years thereafter the taxpayer distributed its profits pursuant to the agreement and it is these distributions which have been held to be dividends.

The vendors conveyed the property to taxpayer and became the sole stockholders.[1] The stock represented, therefore, the full value of the property conveyed. The recital of a purpose to determine later the amount of the difference in values is sheer nonsense. There was no such difference to be determined. The taxpayer's stock was worth whatever the properties conveyed were worth, no more and no less. No attempt has ever been made to determine this mythical difference (R. 13) and nothing has ever been paid on the "balance" of the purchase price. We submit that the taxpayer's whole case falls with this exposure of the fallacy of its premise.

In any event, if the validity of a putative balance should be assumed, we submit that the Board was justified in determining that the Revenue Acts do not authorize the deduction of payments of profits to stockholders. As long as ownership of the stock was vested in the same interests (and since 1927 it has been vested in the one owner, the Water Company) it would make no difference whether or not the "balance" of the purchase price was paid. No reason appears

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[1] It is true that five other shares were issued at the time of incorporation. However, they were admittedly issued merely to qualify directors. (R. 10.) The record does not show to what individuals they were issued or exactly how they were held. For the purposes of this case we can ignore those minority interests. *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552. The record also shows that the Fontana Company was dissolved in 1927 and that its 50 shares of taxpayer's capital stock and rights under the agreement were taken over by the Water Company. (R. 7, 11.) Since all three companies had the same president (R. 7), it is not unreasonable to assume that the Water Company was the parent, or, at least, that all three were closely affiliated.

why the properties could not have been conveyed solely for stock. One share or a million could have been taken and the total value of the stock representing the property would have been the same. In providing for payment to the stockholders of all of the profits over operating expenses, taxes, and the agreed eight percent dividend, the vendors were merely taking what they were entitled to as stockholders and the Board was perfectly justified in deciding that it was paid to them in such capacity.

Merely by setting forth such right in contract form no creditor relationship is established. On this point the taxpayer relied principally on *Commissioner* v. *Palmer, Stacy-Merrill,* 111 F. (2d) 809 (C. C. A. 9th); *Commissioner* v. *Proctor Shop, supra,* and *Arthur R. Jones Syndicate* v. *Commissioner,* 23 F. (2d) 833 (C. C. A. 7th). In the first case this Court upheld decisions by the Board where the facts showed obviously that the payments, although labeled dividends on preferred stock, were in reality payments on a loan. Judge Healey in his concurring opinion pointed out (p. 810) that this Court is committed to the view that "the real intention of the parties is to be sought and in order to establish it evidence aliunde the contract is admissible." As pointed out in that case the *Proctor Shop* case was similar in that there was an obligation to pay "dividends" and to "redeem" preferred stock. Likewise, the *Jones* case was unquestionably a loan although the creditor took debenture shares bearing 14 percent interest to avoid the state usury laws. In none of these cases were the payments made to the true owners, or common stockholders.

It has been pointed out (see *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F. (2d) 971 (C. C. A. 4th)) that the essential difference between the creditor and stockholder relationships is that in the former there is a lending of capital without risk while in the latter there is a desire to embark on a corporate adventure with the attendant risks of loss and chances of profit. Under the agreement in this case there was no lending of capital. The properties were transferred for the common stock. Until an agreed valuation could be made, the vendors received all of the profits—part in the regular form of dividends and the remainder in accordance with the terms of the agreement. The payments were not applied on the purchase price, but as a "temporary" expedient. So far as the vendors were concerned they were in no different position fundamentally than if they had never conveyed the property. They received all the net income from the property and the taxpayer merely carried on the business for their benefit. Certainly such a contract could not have been imposed on an independent purchaser; it was only because the vendors owned the taxpayer lock, stock, and barrel that the latter could conceivably agree to own and operate properties with all the return given to the former owners of the property, until such time as the vendors cared to value the property and secure approval of the Railroad Commission. The payments were to be made solely from the profits; there was no obligation to pay anything unless there were sufficient earnings. They fall squarely within the definition of "dividends" in Section 115 (a), quoted *supra*. In such circumstances, the Board was

justified in holding that the payments were made because of the stock ownership and not from any creditor relationship. Clearly taxpayer did not overcome the presumption of the correctness of the Commissioner's determination and, it is submitted, there was ample evidence to support the Board's conclusion.

Having erroneously reasoned that the payments were made because of a creditor relationship, the taxpayer naturally argues that the payments were interest. Nowhere have the parties termed this payment "interest" which has been defined as "the amount which one has contracted to pay for the use of borrowed money." *Old Colony R. Co.* v. *Commissioner, supra,* p. 560. It is not contended that any money was loaned. The argument appears to be that there was an obligation to pay interest on the difference between the value of the capital stock and the value of the properties. However, as the Board pointed out (R. 18), the payment of all net profits as so-called "interest" absorbed all the taxpayer's resources and made it impossible to pay off the principal. The self-serving nomenclature of the agreement cannot disguise the fact that the vendors here participated in the entire transaction as stockholders, and not as creditors with a secured obligation and a limited return. They bore the risks of loss from the possibilities of profitless operation.

It is suggested (Br. 21) that the agreement could not make the Water Company a stockholder with the attendant liability to creditors. This is pointless. The Water Company was a stockholder because it held the

stock. No one contends that the agreement made it a stockholder. Moreover, the alleged contract rights of stockholders may certainly be made junior to the claims of general creditors. *Taylor* v. *Standard Gas Co.,* 306 U. S. 307; *Pepper* v. *Litton,* 308 U. S. 295.

The intimation (Br. 32) that these payments are analogous to Maryland and Pennsylvania ground rents is equally without merit. As pointed out by the Board, those situations involve feudal relics calling for special treatment. They are in the nature of a deferred payment sale of real estate on the instalment plan, the redeemable ground rent being in reality a mortgage. I. T. 2385, VI–2 Cum. Bull. 185 (1927). In the instant case there was no conveyance subject to a mortgage—no lien of any kind was reserved to the grantors.

Finally the taxpayer contends that these payments are deductible as ordinary and necessary expenses. This is doubtless an alternative argument, since the statutory provisions dealing with interest and with expenses are mutually exclusive. It would be of no assistance to this Court to discuss the cases cited upon this point. They involve different facts and merely show that under other circumstances deductions may be allowable even though the payments were made to vendors or to stockholders. They do not show that the Board erred in carefully scrutinizing the dual relationship of the payees and they do not countenance a blind adherence to the form which taxpayers give to their transactions. As heretofore pointed out, this Court is committed to the view that the substance of the transaction should control. Here the substance was the payment

to the sole stockholder of all profits as such and the Board correctly disallowed the claimed deductions.

CONCLUSION

The decision of the Board of Tax Appeals was correct, founded on substantial evidence, and should be affirmed.

Respectfully submitted,

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